This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 03 HANOI 002237

SIPDIS

STATE PASS USTR FOR EBRYAN
STATE ALSO PASS USAID ANE
TREASURY FOR OASIA
USDOC FOR 4431/MAC/IFP/OKSA/HPPHO
BANGKOK FOR USAID

SENSITIVE

E.O. 12958: N/A
TAGS: EFIN ECON VM SOE FINREF
SUBJECT: MONETARY POLICY IN VIETNAM

This cable contains sensitive information and should not be posted on the internet.

¶1. (SBU) Summary: Responsibility for monetary policy-making rests with the State Bank of Vietnam (SBV), which functions as a central bank as well as the owner and supervisor of the State-owned commercial banks (SOCB). For 2005, the SBV decided to focus on controlling the monetary aggregate, restraining credit growth from its 42 percent level in 2004 and stabilizing the exchange rate. The SBV has begun to act more indirectly to manipulate the money market. While the Government blames recent inflation on supply-side and external shocks like rising global rice and oil prices, avian influenza, a persistent drought and loose monetary policies may also contribute. Continued policy lending between State-owned enterprises (SOE) and State-owned commercial banks has fueled rapid credit expansion and may pose future risks. End Summary.

MONETARY POLICY MAKING

¶2. (SBU) The State Bank of Vietnam (SBV) is the central bank as well as the owner and supervisor of the State-owned commercial banks (SOCBs) which still dominate Vietnam's financial sector. For many years, monetary policy in Vietnam was simple: the SBV made sure there was adequate liquidity for SOCBs to fund state-owned enterprises (SOEs). Tight government controls on access to foreign exchange, as well as a fixed exchange rate, insulated the economy from external shocks and minimized the need for sophisticated monetary policy making. Relative to its neighbors, the country was largely untouched by the 1997 Asian financial crisis, not because of policy prowess, but because of its limited integration with the regional economies most affected by the crisis. As Vietnam's economy has gradually become more open, it has faced greater exposure to external shocks, exchange rate fluctuation and the need to develop a monetary policy. In recent years, the IMF has sponsored technical assistance programs to give SBV officials a better understanding of market-based monetary control techniques. At the same time, the SBV's increasing reliance on indirect instruments such as open market operations, which were first introduced in 2000 and still in their nascent stages, have given the SBV somewhat more influence in the domestic money market.

¶3. (SBU) Vietnam's constitution assigns the SBV responsibility for creating an annual set of monetary policy objectives. Following approval by the Government and the National Assembly, the SBV sets the specific policies to meet these objectives. SBV's Monetary Policy Office's Deputy General Director Nguyen Ngoc Bao said that policy makers had agreed on 2005 growth rate targets of 8.5 percent for GDP and 6.5 percent for the Consumer Price Index (CPI). Based on those targets, SBV has determined its own secondary objectives for 2005, namely controlling the monetary aggregate, restraining credit growth and stabilizing the exchange rate. Bao noted that interest rates have recently been liberalized and are now largely controlled by market forces. The SBV only manipulates the discount rate to control bank credit, which is the main source of capital for the Vietnamese economy.

¶4. (SBU) The SBV faced its first recent inflationary challenge in 2004 when CPI reached ten percent. Vietnam's annual inflation rate had been consistently below four percent since 1998, and had not been in the double-digits since 1995. Bao attributed the rapid inflation rate to higher prices for imported raw materials, the return of avian influenza, price increases for rice on the global market and distribution problems, particularly for pharmaceutical products. 1Bao downplayed the impact of loose monetary policy as a factor contributing to inflation. In order to manage last year's inflation, he explained that the SBV had adjusted its benchmark discount rate, raised the required reserve ratio and restrained the money supply. The SBV has been maintaining a cautious monetary policy stance

throughout 2005, Bao added. Since the SBV introduced open-market operations five years ago, the response from the market has been encouraging, with electronic trading sessions now taking place three to five times each week. An SBV committee is responsible for managing open-market operations, which Bao said has been very effective in manipulating the money market. The SBV plans to use open-market operations increasingly as a policy instrument.
¶5. (SBU) According to Nguyen Thi Vu, the SBV's inflation expert and manager of the Economic Analysis and Forecast Division, the SBV is continuing to reevaluate the CPI basket in order to represent core inflation values more accurately. Food and foodstuff prices constitute about 48 percent of Vietnam's CPI, which was originally calculated based on a survey of household expenditures in 2000. SBV officials acknowledge that a rising standard of living, especially in urban areas, has already altered consumer spending habits, probably reducing the share of income spent on food items. While the General Statistics Office (GSO) plans to complete a survey on household expenditures by 2005, the SBV's inflation expert said preliminary data from the survey shows that food still represents more than 40 percent of the CPI's weighted prices.

¶6. (SBU) According to International Monetary Fund Country Representative Susan Adams, the GVN's efforts to combat inflation have been somewhat misdirected. In recent years, the GVN has been reluctant to tighten monetary policy because of a largely political commitment to sustain growth numbers before the five-year plan terminates at the end of
¶2005. Besides that, the SBV attributes the rising prices to temporary supply shocks resulting from continued drought, avian influenza and inflationary trends on the international market. Adams said the IMF has encouraged the SBV to implement tighter monetary policies. The IMF is also encouraging the SBV to more frequently use indirect monetary instruments, like open-market operations.

¶7. (SBU) One of the SBV's primary objectives is to ensure an adequate supply of capital for continued growth. Credit growth was 41.6 percent last year - a rate Bao considered reasonable in order to sustain the economy's 7.7 percent GDP growth rate for 2004. The SBV is less concerned about credit growth because of the high level of investment for borrowed capital, he added. The SBV's major challenge is to expand lending while improving loan quality. Efforts to this end are reflected in commercial bank restructuring, which include implementing risk management regulations. Bao also mentioned poor-quality bank loans and a high level of dollarization as added challenges for the SBV.

¶8. (SBU) Borrowing and lending remain unrestrained, especially for the state-owned sector, according to Adams. This credit expansion reflects persistent structural problems, as state-owned banks continue to extend politically motivated loans to faltering state-owned firms. Joint stock and private domestic enterprises also represent a growing proportion of bank lending. The SBV's contractionary monetary policies in 2004 did very little to affect credit growth. Nevertheless, Adams believes rapid credit expansion is not directly correlated with inflation, but could be a contributing factor in the future if monetary policy remains loose. To a limited extent, credit expansion is also an encouraging sign of positive intermediation in the economy, as well as growing public confidence in financial institutions.

FOREIGN EXCHANGE RESERVES

¶9. (SBU) The SBV's Foreign Exchange Management Department Deputy Division Chief Nguyen Chi Thanh estimates foreign exchange reserves for Vietnam at 10-12 import weeks. While the SBV officially refers to the exchange rate policy as a "regulated market policy," the policy functions like a "crawling peg" exchange regime. The GVN has taken a heavy-handed approach to foreign exchange rates, according to Adams. Vietnam's crawling-peg policy has further weakened its already weak foreign exchange position, making it even more vulnerable to external supply shocks. Vietnam's dollarized economy has also become a cause of concern for the SBV. At least in urban areas, a number of businesses accept U.S. dollars as well as Vietnam dong and change in dollars.

¶10. (SBU) Comment: Even though SBV officials are still honing their monetary policy making skills, Vietnam's monetary policy has been prudent over the last year with a few exceptions. In its capacity as a central bank, however, the SBV would do well to limit its politically motivated decisions. Specifically, the SBV's initial reluctance to tighten monetary policy in the face of rapid inflation may have been politically motivated. In any case, the IMF considers that the impact of interest rate changes is unclear. The exchange rate position might benefit from looser controls. Better risk management and less policy

lending will be needed to control inflation as well as credit growth to SOEs in the future. End Comment.

MARINE

1Sam: I could not read your comment on this. I added what I could make out.